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SUBJECT: 2009 SHANGHAI FDI SNAPSHOT

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¶B. SHANGHAI 444

(U) This document is sensitive but unclassified. Please protect accordingly.

¶1. (SBU) Summary: In 2009, Shanghai's foreign direct investment (FDI) continued to grow despite China's dramatic drop in nationwide FDI. Municipal officials and academics report that Shanghai's increasingly service-based economy, the Central Government's anointment of Shanghai as a future international financial and commercial center, new local regulations empowering district-level governments, and intense competition with other jurisdictions in the Yangtze River Delta Region are factors causing the Municipality's FDI strategy and development to differ from other jurisdictions in China. The potential effects of renminbi (RMB) appreciation and the proposed Shanghai Disneyland project on FDI remain unclear. End Summary.

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FDI Growth...Just Barely

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¶2. (SBU) According to the Shanghai Municipal Commerce Commission (SCOFCOM), during the first ten months of 2009, Shanghai's utilized FDI grew 3.0 percent, compared with the same period in ¶2008. When compared to China's nationwide numbers, Shanghai's anemic three percent growth rate looks relatively strong. Over the first ten months of 2009, nationwide FDI dropped 12.6 percent, with a year-on-year drop of 35.7 percent in July.

¶3. (SBU) The U.S. is the third largest foreign direct investor in Shanghai, after Hong Kong and Japan. SCOFCOM Foreign Investment Promotion Department Director Tian Zhongfa admitted that having Hong Kong in the number one spot for FDI is misleading. He stated that the origins of investment from Hong Kong are notoriously difficult to identify, often initiating in a foreign country and being funneled through the Hong Kong branch of a foreign bank.

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The Blessing and Curse of Shanghai's Increasingly Service-Based Economy

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¶4. (SBU) Shanghai has structured its FDI policies to effect a transition from a manufacturing-based to a service-based economy since the early 1990s. This transition strategy recently gained momentum on the national level when, in April 2009, the State Council in Beijing announced the goal for Shanghai to become an international financial center by 2020 (ref A). SCOFCOM officials noted that the vast majority of new FDI flows into the service sector, reflecting the central government's ambition to turn Shanghai into a service economy. During the first 10 months of 2009, 89 percent of FDI contracts were in the service sector, up from 87 percent in 2008, and 80 percent in 2007.

¶5. (SBU) It appears that Shanghai's increasingly service-based economy insulated the Municipality from the staggering drop in FDI seen in other parts of China in 2009. Zhejiang and Jiangsu, whose economies are more dependent on manufacturing, saw a 13.5 percent and 14.6 percent drop, respectively, in FDI during the first half of 2009, compared with Shanghai's 2.5 percent growth in that period.

¶6. (SBU) However, local academics indicate that there might be some obstacles to completely achieving the goal of a service economy. Dr. Xu Mingqi, Professor and Deputy Director of the Institute of World Economy at the Shanghai Academy of Social Sciences, cited to congenoff administrative barriers and market fragmentation within the Yangtze River Delta region as factors contributing to Shanghai's slow transition to a service economy. Shanghai-based service companies (law firms, consultancies, financial services firms) are sometimes blocked from competing in the region outside Shanghai Municipality, limiting the city's ability to become a regional services hub. Dr. Xu said this was especially true in the banking and legal professions, which are often limited in their ability to establish branch offices. In addition, the competitive dynamic in the region means that Shanghai's neighboring provinces and cities are loathe to lower administrative barriers for fear of more advanced Shanghai-based services firms poaching market share from their own local companies.

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The Role of Regulation: Empowering Shanghai's Districts

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¶7. (SBU) In August 2009, the Shanghai Municipal Government greatly relaxed the foreign investment approval process by giving district-level authorities the power to approve foreign investment projects valued at up to US$100 million. The previous threshold for district-level approval was US$30 million. Along with the Ministry of Commerce (MOFCOM) in Beijing, SCOFCOM will still maintain tight control over investment in sensitive sectors and very large investments, but will now spend less time reviewing projects. This will enable the municipal government to focus its efforts on "creating a stable environment for investment", and less time acting as a clearinghouse for projects, according to SCOFCOM's Investment Promotion Director Tian. Dr. Xu stated that any reduction in bureaucracy would be viewed by investors as a positive step, and that cutthroat competition between Shanghai's districts should attract more investment. Furthermore, he pointed out that district-level authorities now controlled most of the incentives used to attract international investors, including the ability to offer tax rebates, cash subsidies, as well as housing and special tax treatment for executives.

¶8. (SBU) Districts in Shanghai are embracing their new powers. On November 20, congenoff attended Xuhui District's 2009 International Advisory Council Meeting, an open forum to discuss goals and strategies for economic growth and attracting foreign investment. (Note: Located in the center of Shanghai, Xuhui District has a population of almost one million, and in recent years has developed into a commercial center and one of the

major retail shopping areas in Shanghai. End note.) Ideas discussed included: positioning Xuhui to play a leading role in the development of Shanghai as an international trade center; the types of incentives that should be offered to international investors; and the creation of an international legal hub with the headquarters of law firms all in a centralized location -- similar to Pudong District, which is home to most of Shanghai's financial services firms. The nature and substance of the meeting demonstrated the sophisticated nature of economic development on the district level and the depth of the transition to a service economy in certain areas of Shanghai.

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Shanghai's Real Estate Sector: Still Open for Foreign Investment

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¶9. (SBU) Director Tian was not concerned about foreign investment overheating Shanghai's property market. On the contrary, he was keen to point out that foreign investment in the real estate sector is crucial to Shanghai's emergence from the economic crisis, and all but assured congenoffs that real estate would not be named on an updated list of Shanghai Municipality's investment sectors prohibited to foreign investors. Managers at E-house (China) Holdings Limited -- a NYSE-listed real estate services company -- also played down the idea that foreign investment in real estate is overheating the sector. E-house Director of International Product & Business Development Robert Fong noted that a lack of supply and rising prices in the residential market, particularly the luxury market, is balanced by overcapacity in the commercial sector (the firm estimates 30 percent of office space in Shanghai is empty). Nevertheless, he expected a regulatory shift would increase restrictions on real estate investment in late 2010 or early 2011 to maintain control of the sector.

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Stiff Regional Competition for FDI

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¶10. (SBU) "Fierce, with no one willing to back down," is how Dr. Frank Peng, Professor of Economics and Finance at Tongji University and Senior Advisor to the Foreign Investment Board of the Shanghai Municipal Government, described the competition for foreign investment between Zhejiang Province, Jiangsu Province, and Shanghai Municipality to congenoffs. SCOFCOM's Director Tian similarly explained that regional competition for FDI has become much more of an issue for Shanghai than it was just a few years ago. Previously, Shanghai's infrastructure and geographic location alone convinced foreign investors that it was the best place for their assets. Presently, with the costs of living, labor, and land steadily rising in Shanghai, foreign companies are moving operations to Jiangsu and Zhejiang, which have developed and refined their economies very quickly, diminishing Shanghai's competitiveness. Additionally, Dr. Peng pointed out that Jiangsu and Zhejiang Provinces are no longer content to take old manufacturing capital fleeing Shanghai's high production costs. These provinces are now actively recruiting service industry investment and high-end research and development in the pharmaceuticals, biotech, and biomedical sectors, all of which Shanghai is also targeting (Ref B). Dr.

Xu agreed that Shanghai's competitive advantage for attracting FDI has dwindled considerably. He pointed out that Shanghai's policy of transitioning to a service economy is rather convenient since even without such a policy, the rising cost of production would have forced Shanghai to cede most of the manufacturing sector to Zhejiang, Jiangsu and other provinces.

¶11. (SBU) According to Dr. Xu, Shanghai's competitive advantage is that it has a relatively efficient, credible government with a history of protecting investor's interests. Furthermore, Shanghai's legal infrastructure is unparalleled in China, particularly when it comes to business law. In addition, SCOFCOM's Tian noted that domestic consumers perceive Shanghai products and services to be of extremely high quality. He stated that international investors should consider this factor when determining where to make their investment.

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The FDI X factors: The Role of the RMB and Disneyland

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¶12. (SBU) A number of interlocutors referenced the role of the RMB in attracting FDI into Shanghai. Professors Xu and Peng both stated that RMB appreciation would help stimulate a short-term, nationwide "recovery" in FDI, attracting back some of the hot money that disappeared when the exchange rate froze in 2008. Long-term, they did not think FDI would suffer from a gradual RMB appreciation, as long as the Chinese economy continues to grow at a steady pace. While neither professor was willing to indicate whether he thought the RMB would appreciate in the near future, both referenced a gradual adjustment to come at some point in the future. Dr. Peng also stated that Shanghai cannot realize its full investment potential and receive the investment necessary to become a true international financial center as planned by 2020 without RMB convertibility. He claimed officials in Shanghai and Beijing are well aware of this fact. Consequently, although short-term moves on the RMB are

unpredictable, convertibility is expected before 2020, and with it a still greater rush of foreign investment into Shanghai.

¶13. (SBU) Another factor that could have a dramatic effect on foreign investment is the much feted Shanghai Disneyland project. Media sources estimate that a $3.7 billion investment is planned. Speculation is rife regarding how much additional investment will be attracted to Shanghai as a result of the project, formal approval of a first phase of which was announced in November 2009. Mr. Fu Qi, Shanghai Branch Project Manager at E-House, was pessimistic, predicting that investment in property will not extend much beyond the Disney site itself in a less settled part of Shanghai's Pudong District. E-House expects that many people will want to stay in hotels downtown, not by Disneyland, and that employees would likely live in more heavily-developed areas of Pudong. Dr. Peng worried that Shanghai Disneyland would meet a similar fate as the Disney parks in Hong Kong and Paris and struggle to make a profit. Dr. Xu, however, was more bullish, envisioning the creation of an entirely new economy in Shanghai, unique from other surrounding provinces and guaranteeing sustained investment to the city for many years to come.

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Comment

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¶14. (SBU) To a certain extent, FDI numbers march to the beat of their own drum in Shanghai. The city's continuing shift to a service-based economy and innovative policies to attract investment seem to have detached it somewhat from negative nationwide FDI trends over the last year. In order to keep pace with opportunistic neighboring provinces offering feasible investment alternatives for foreign companies, Shanghai will likely be forced to continue loosening its regulatory grip on investment. Despite the fierce competitive environment in the Yangtze River Delta, with official designation as a future international financial center and massive development projects such as Disneyland, Shanghai has established a path for future FDI growth -- one that is likely to deviate to some extent from overall patterns of investment into China.
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